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Supreme Court, U. S.
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IN THE

Supreme Court of the United States,

October Term—1933.

No. 180.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

DONALD H. OWENS and MARION HAVILAND OWENS,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR RESPONDENTS.

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In the

Supreme Court of the United States.

October Term, 1938.

Guy T. Helvering, Commissioner of Internal Revenue,
Petitioner,

vs.

Donald H. Owens and Marion Haviland Owens,
Respondents.

No. 180.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

BRIEF FOR RESPONDENTS.

Opinions of the Courts Below.

The memorandum opinion of The Board of Tax Appeals (R. 6-9) is unreported. The opinion of the Circuit Court of Appeals (R. 15-16) is reported in 95 F. (2d) 318.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered March 14, 1938 (R. 17). On motion of the petitioner, this Court entered an order on June 2, 1938, extending the time for filing a petition for writ of certiorari for sixty days from June 7, 1938. A petition for a writ of certiorari was filed July 6, 1938 and was granted October 10, 1938 (R. 17). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

Question Presented.

Whether, for Federal Income Tax purposes, the amount of the deduction allowable upon the destruction of a pleasure automobile, where only a salvage value remains, is measured by the difference between the cost of the car and the salvage value thereof, or is limited to the difference between the value of the car before the accident and its salvage value.

Statement of Facts.

The facts have been correctly summarized in the statement of facts made at pages 2-3 of the petitioner's brief.

Statutes Involved.

Revenue Act of 1934, c. 277, 48 Stat. 680.

"Section 23.—Deductions From Gross Income:

In computing net income there shall be allowed as deductions:

* * * * * * *

(e) Losses by Individuals.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

* * * * * * *

(h) Basis for Determining Loss.—The basis for determining the amount of deduction for losses sus-

tained, to be allowed under subsection (e) or (f), shall be the adjusted basis provided in section 113(b) for determining the loss from the sale or other disposition of property."

"Section 113.—ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) BASIS (UNADJUSTED) OF PROPERTY.—The basis of property shall be the cost of such property; except that—

* * * * * * *

(b) ADJUSTED BASIS.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—

* * * * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *"

(C) in respect of any period prior to March 1, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

* * * * * * *

Summary of Argument.

The issue of law presented herein is identical with that presented in the case of *Amedeo Obici and Mrs. Amedeo Obici (Husband and Wife)* v. *Guy T. Helvering, Commissioner of Internal Revenue* now pending here (October Term, 1938, Number 318) on writ of certiorari granted to the United States Circuit Court of Appeals for the Fourth Circuit, in which case the taxpayers are the petitioners to this Court. The *Obici* case has been placed upon the calendar of

this Court for argument immediately following the case herein (Number 180). The arguments advanced in petitioners' brief in Number 318 are of equal applicability to the issue presented herein (Number 180) and are adopted and incorporated herein by reference.[1]

In the *Obici* case (No. 318) the taxpayers' boat, boathouse and pier, not used in a trade or business, were totally destroyed by storm. In the case herein presented the respondents' pleasure car was destroyed by an accident so that only a salvage value remained. The existence of a salvage value does not render different principles applicable to the case presented herein. Where such salvage value remains, it is simply to be subtracted from the "basis" in determining the amount of deductible loss. Regulations 86, Article 23(e)-1 provides in part as follows:

> * * * "Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. See section 113(b)."

Article 23(e)-3 of Regulations 86 also provides that in determining the amount of the deduction where loss of useful value is sustained on business property the amount of the deduction is the difference between the prescribed "basis" and "the salvage value of the property".

In the instant case the Board of Tax Appeals found that respondents' automobile was wrecked and partly demolished

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[1] The *Obici* case (Number 318) is governed by the Revenue Act of 1932. The case herein (Number 180) is governed by the Revenue Act of 1934. The provisions of the two Acts, insofar as material to the issue presented, are in all respects alike. Section 23(e)(1), (2) and (3) and Section 23(f) of each Act governs property losses. The "basis" section for determining the amount of the loss allowable under Section 23(e) in the Revenue Act of 1932 is numbered Section 23(g); in the Revenue Act of 1934 it is numbered Section 23(h). In applying petitioners' brief in Number 318 to this case "Section 23(g)" should be read as "Section 23(h)," the equivalent section in the Revenue Act of 1934. The pertinent provisions of Section 113(a) and (b) in the Revenue Act of 1932 and the Revenue Act of 1934 are identical.

so that only a salvage value remained (R. 8). In the opinion of the Board of Tax Appeals, the Board stated:

> "It is apparent from the stipulation of the parties, to the effect that the automobile was wrecked and partly demolished so that a salvage value only remained, that a complete loss resulted except for the value of the salvage remaining after the collision" (R. 8).

In cases involving slight damage where the property can be repaired at a relatively small expense, retains its useful value, and continues to be used by the taxpayers for the purposes for which it was acquired, then the loss deduction is determined by some other measure independent of cost, such as the cost of repairs. The facts here, however, indicate a loss of useful value and the existence of only a salvage value after the wreck.

The fact that the salvage value here was not greatly below the value of the car before the wreck is due to the fact that a car which is completely wrecked has a high "trade-in" value as an inducement to buy a new car.

Where the property is "partly demolished" so that for practical purposes all *useful* value is lost and only a junk or salvage value remains respondents submit that under Section 23(h) and Section 113 (b) the proper measure for computing the deductible loss is cost, less salvage value.

ARGUMENT.

I.

Petitioner's argument that the Circuit Court below erred in permitting an unauthorized deduction for depreciation in the case of nonbusiness property, is not within the scope of petitioner's specification of errors.

The crux of petitioner's argument is that the decision below, by reason of the employment of cost as a "basis", permits indirectly the deduction of depreciation sustained in prior years on property not used in a trade or business, where the statute does not permit a deduction for physical wear and tear as such. Petitioner even argues that "the amount of depreciation of the automobile must be subtracted from the original cost in order to determine the amount of what has been subjected to loss."[1] Petitioner's brief, page 10.

Petitioner, in his specification of errors to be argued before this Court, alleges only that the Circuit Court of Appeals erred in failing to hold that the amount of the deduction allowable to respondents is the difference between the fair market value of the automobile immediately before the accident and its value thereafter. (Petition for the Writ of Certiorari, p. 5; Petr.'s Br., p. 4.) Petitioner now apparently contends as well that the Court below erred in failing to hold that cost less "the amount of depreciation of the automobile" was the proper basis. Petitioner's brief, page 10. Such a contention does not come within the scope of petitioner's allegations of error.

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[1] This same argument was advanced by the Government in *United States* v. *Ludey*, 274 U. S. 295, and was rejected by this Court which then held that the cost under the 1916 Act should be reduced by the amount of depreciation and depletion which "the taxpayer was entitled to deduct in the several years" prior to the year of sale.

Cost less depreciation is not necessarily the same as fair value before the casualty. A suit of clothes or a personal automobile when purchased and converted to personal uses for even a short while, decreases in value owing to other factors at a far greater rate than the rate of actual physical depreciation. On the other hand a residence while physically depreciating may at the same time actually increase in value. It is submitted that petitioner's specification of errors does not include within its scope an allegation that the Circuit Court erred in not subtracting physical depreciation from cost in determining the proper basis for computing the amount of the deductible loss. If the specifications are broad enough to permit such an allegation it should be denied as unsound. *United States* vs. *Ludey*, 274 U. S. 295.

2.

There are numerous instances in the revenue acts and the cases thereunder permitting the use of a "basis" under the "basis sections" which indirectly gives the taxpayer the benefit of unallowable depreciation physically sustained in prior years.

Petitioner argues that the use of cost as a basis permits the taxpayer to receive the benefit of depreciation deductions which were unallowable and unauthorized in prior years and that for this reason a special limitation should be found in the words "losses sustained during the taxable year" in Section 23(e). (Petr.'s Br., pp. 9, 10, 11.)

There are numerous instances in the Revenue laws where the basis authorized, and the loss computed thereunder, may indirectly include as part of the loss allowed, physical depreciation sustained in prior years and unauthorized as a deduction by any of the Revenue Acts. The Revenue Act of 1924, is the most striking example. Section 214(a)(4) of

that Act provided that in computing net income there should be allowed as a deduction "losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business". Under Section 204(a) the basis prescribed for determining gain or loss was cost. Section 202(a) provided that the deductible loss should be the excess of "such basis" (cost) over the amount realized. Section 202(b) provided—

> "In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account, and (2) any items of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, *previously allowed* with respect to such property." [1] (Italics supplied.)

Under these Sections the question arose whether (1) an adjustment should be made under Section 202(b) for depreciation sustained on the property for years prior to the income tax laws and (2) whether adjustment should be made for the excess of depreciation actually physically sustained over that *actually allowed* by the Commissioner as deductions in previous years.

The Board of Tax Appeals, the Courts, and the Treasury Department itself failed to find that the words "losses sustained during the taxable year" contained in Section 214(a)(4) of the Revenue Act of 1924 required an interpretation of Section 202(b) of that Act such as would disregard and circumvent the literal meaning of that Section. The General Counsel's Office of the Bureau of Internal Revenue at first ruled that the "basis" was required to be reduced by Section 202(b)(2) of the Revenue Act of 1924 "only for deductions (depreciation) which have in prior years been actually granted by the Commissioner in computing the net income of the taxpayer," and that it was not required that the "basis"

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[1] The adjustment required under the 1934 Act is for depreciation "allowed" or "allowable," whichever is greater.

be reduced by the amount of physical depreciation actually sustained before 1909. *G.C.M. 8573*, Cumulative Bulletin IX—2, page 168. See also *S.M. 4249*, Cumulative Bulletin IV—2, page 15.

The Board of Tax Appeals in *Ann Arbor Railroad Co. v. Commissioner*, 29 B.T.A. 331, held that the "basis" should be reduced by depreciation actually and physically sustained on the property prior to 1909. Accordingly, the General Counsel's Office revoked *G.C.M. 8573* (*supra*) and *S.M. 4249* (*supra*) in *G.C.M. 10754*, Cumulative Bulletin XI—2, page 177. However, the Board of Tax Appeals in *Union Pacific Railroad Co. v. Commissioner*, 32 B.T.A. 383, reversed its former decision in the *Ann Arbor Railroad* case (*supra*) and held that the "basis" should not be reduced for depreciation actually sustained but not allowed (before 1909). The Board was affirmed by the Second Circuit in 86 F. (2d) 637. The same conclusion was reached in *Helvering v. St. Louis Southwestern Railway Co.*, 84 F. (2d) 857. In view of these cases the General Counsel in *G.C.M. 18611*, Cumulative Bulletin 1937—1, page 235, revoked *G.C.M. 10754* (*supra*) and reinstated *G.C.M. 8573* (*supra*).

In the *Union Pacific Railroad Co.* case (*supra*) the reasons of the Board were set forth in the opinion (pp. 395-397) as follows:

> "For any year prior to 1924, the determination of gain or loss upon the sale or disposition of depreciable property was governed by a statute which made no mention of an adjustment for prior depreciation. Whether depreciation should be taken into account in the computation and, if so, whether the measure of such depreciation should be the amount "sustained", or the amount accounted for on the books, or the amount deducted on the returns, was a question upon which there was no consensus. The Revenue Act of 1924 was a deliberate attempt by Congress to set the question at rest. The Treasury sought legislative sanction for its regulation and practice of deducting original cost by depreciation regarded as actually sustained. Regulations 45, art. 1561, or sustained and allowable, Regulations 62, art.

1561, irrespective of the extent to which such depreciation had been actually used as a factor of tax computation. This, however, the Congress failed to adopt. It provided for an adjustment for prior depreciation, but expressly limited such adjustment to the depreciation "previously allowed". Cost was left undistributed in arriving at the basis, section 204, and the adjustment was povided for in the computation of gain or loss in section 202.

We can find no justification for the view, urged by respondent, that the term "cost", used in section 204, means depreciated cost or cost less depreciation. Since provision was explicitly made in section 202 for the depreciation adjustment in computing gain or loss, there is no ground for an inference that a similar adjustment is, by implication, to be imported into section 204. This would result in the same sort of illogical computation as the Government was seeking, by the new statute, to prevent.

That there was reason for Congress to limit the adjustment to so much as had inured to the taxpayer's tax benefit and to disregard the depreciation which had had no tax effect, is apparent from United States v. Ludey, supra, in which the Supreme Court reasoned to a similar conclusion under the earlier acts.

The respondent sets forth supposititious cases to demonstrate what he regards as the absurd effect of disregarding actual depreciation of earlier years. These illustrations are, however, so common-place that it is difficult to believe that they escaped legislative consideration. On the other hand, there is more to be said for the view that Congress recognized the diverse views and practices which had marked the history of depreciation, and sought to adopt a simple computation which would avoid the difficulties which the concept of sustained depreciation would entail' " * * *. (Italics supplied.)

See also *United States* v. *Ludey, supra*, where this Court held under the 1916 Act that cost should not be reduced by depreciation "sustained" but only by the aggregate of the depreciation which was *deductible* under the income tax laws.

3.

In the computation of gain as well as in the computation of losses Congress has enacted specific ameliorating provisions for taxpayers who have been deprived of the useful value of their property through fire, storm, shipwreck, or other casualty, or theft.

In *Amedeo Obici and Mrs. Amedio Obici* v. *Helvering*, No. 318, the Fourth Circuit suggested that unintended error crept in when the casualty loss provisions were drawn and intimated that Congress intended no special "tax benefits" in the case of casualty loss.

On the contrary, Congress has definitely shown a desire to accord special consideration to those taxpayers who are involuntarily deprived of the use of their property. This extends even to those cases where a profit (from insurance for example) may have resulted. Section 112(f) of the Revenue Act of 1934 provides as follows:

> "(f) INVOLUNTARY CONVERSIONS.—*If property (as a result of its destruction* in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) *is* compulsorily or *involuntarily converted into* property similar or related in service or use to the property so converted, or into *money* which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, *no gain* or loss *shall be recognized*. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended." (Italics supplied).

Section 112(f) or substantially similar Sections has been in the law since the Revenue Act of 1921, where it first appeared as Section 214(a)(12). The legislative history of the Revenue Act of 1921 reveals a legislative intent to confer ameliorating benefits upon the taxpaper who is deprived of his property by a sudden force over which he has no control. Thus, the Report of the House Ways and Means Committee on the Revenue Act of 1921, 67th Congress, First Sessions, H. R. Report No. 350, page 12, provides:—

> "Section 217 (Section 214(a)(13) in the final draft) deals with cases where property is involuntarily converted into cash as a result of fire, shipwreck, condemnation, or related causes; and permits the taxpayer to omit or deduct the gains involuntarily realized, when he proceeds forthwith in good faith to invest the proceeds of such conversion in the acquisition of similar property or in the establishment of a replacement fund therefor." (Parentheses supplied.)

4.

The rule applicable to adjustments for depreciation on business properties set forth by this court in *United States* vs. *Lesley* is equally applicable to non-business "casualty" losses and supports respondents' contentions.

The case of *United States* vs. *Lesley*, (*supra*) involved the computation of gain or loss on a sale of business property in 1917. The Revenue Act of 1916 which governed the transaction made no specific provisions for adjustments on account of depreciation in determining the gain or loss. The Government argued that all depreciation previously actually *sustained* on the property should be deducted from cost in computing the "basis" and that "for this reason, the cost to plaintiff of the net property sold in 1917 was not $95,977.33 but $53,258.36". The taxpayer contended that cost was the

proper basis because the Revenue Act contained no provisions with respect to adjustments for depreciation. This Court rejected the contentions of both the taxpayer and the Government, Justice Brandeis stating in the course of the opinion—

> "* * * On the other hand, we cannot accept the government's contention that the full amount of depreciation and depletion *sustained*, whether allowable by law as a deduction from gross income in past years or not, must be deducted from cost in ascertaining gain or loss. Congress doubtless intended that the deduction to be made from the original cost should be the aggregate amount which the taxpayer was *entitled to deduct* in the several years" (Italics supplied).

Thus this Court has held in the total absence of provisions relating to adjustments on account of depreciation, that cost will be reduced only by the amount of the aggregate of depreciation which the taxpayer was entitled by law to deduct in determining net income for prior years. In the present case no depreciation was deductible by reason of the fact that the property was acquired and used for non-business purposes. The law was amended in 1924 to include a provision that depreciation should be deducted to the extent that it had been actually "allowed" as a deduction in prior years. The 1926 and 1928 Revenue Acts provided for an adjustment on account of the depreciation which was "allowable". Revenue Act of 1926, Section 202(b)(2); Revenue Act of 1928, Section 111(b)(2). This is in effect the rule as stated in the *Ludey* case. Later Acts required that cost be decreased on account of depreciation "allowed" but not less than depreciation "allowable". Revenue Acts of 1932 and 1934, Section 113(b)(1)(B). It is only for the *period prior to March 1, 1913*, that cost is reduced by depreciation actually *sustained* on the property. Revenue Acts of 1932 and 1934, Section 113(b)(1)(C).

Respondents respectfully submit that the rule as stated by this Court in the *Ludey* case in computing gain or loss

upon the sale of business property under the 1916 Law is equally applicable to computing the loss from a casualty to non-business property under the 1932 Law.

The property here was acquired *after* March 1, 1913. No depreciation was "allowed" or "allowable" and the taxpayer had no previous deduction on account thereof. Cost undiminished by physical depreciation or by subsequent fall in value constitutes the proper "basis" for measuring the deduction to which the respondents are entitled on account of the loss of property sustained.

Conclusion.

The Circuit Court of Appeals for the Second Circuit was correct in holding that the proper basis for measuring the deduction in the instant case was cost, and its judgment should be affirmed.

Respectfully submitted,

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SUPREME COURT OF THE UNITED STATES.

Nos. 180, 318.—October Term, 1938.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, 180 vs. Donald H. Owens and Marion Haviland Owens.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.
Amedeo Obici and Mrs. Amedeo Obici, Petitioners, 318 vs. Guy T. Helvering, Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

[January 3, 1939.]

Mr. Justice Roberts delivered the opinion of the Court.

The courts below have given opposing answers to the question whether the basis for determining the amount of a loss sustained during the taxable year through injury to property not used in a trade or business, and therefore not the subject of an annual depreciation allowance, should be original cost or value immediately before the casualty.[1] To resolve this conflict we granted certiorari in both cases.

In No. 180 the facts are that the respondent Donald H. Owens purchased an automobile at a date subsequent to March 1, 1913, and prior to 1934, for $1825, and used it for pleasure until June 1934 when it was damaged in a collision. The car was not insured. Prior to the accident its fair market value was $225; after that event the fair market value was $190. The respondents filed a joint income tax return for the calendar year 1934 in which they claimed a deduction of $1635, the difference between cost and fair market value after the casualty. The Commissioner reduced the deduction to $35, the difference in market value before and after the

[1] Helvering v. Owens, 95 F. (2d) 318; Helvering v. Obici, 97 F. (2d) 431.

collision. The Board of Tax Appeals sustained the taxpayers' claim and the Circuit Court of Appeals affirmed its ruling.

In No. 318 it appears that the taxpayers acquired a boat, boathouse, and pier in 1926 at a cost of $5,325. In August 1933 the property, which had been used solely for pleasure, and was uninsured, was totally destroyed by a storm. Its actual value immediately prior to destruction was $3905. The taxpayers claimed the right to deduct cost in the computation of taxable income. The Commissioner allowed only value at date of destruction. The Board of Tax Appeals held with the taxpayers but the Circuit Court of Appeals reversed the Board's ruling.

Decision in No. 180 is governed by the Revenue Act of 1934,[2] in No. 318 by the Revenue Act of 1932.[3] The provisions of both statutes touching the question presented are substantially the same and we shall refer only to those of the 1934 Act. Section 23(e)(3) permits deduction from gross income of losses "of property not connected with the trade or business" of the taxpayer, "if the loss arises from . . . casualty." Subsection (h) declares that "The basis for determining the amount of the deduction for losses sustained, to be allowed under subsection (e) . . . , shall be the adjusted basis provided in section 113(b)." Section 113 is entitled "Adjusted basis for determining gain or loss"; in subsection (a) it provides that "The basis of property shall be the cost of such property", with exceptions not material. Subsection (b), to which 23(h) refers, is: "*Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided. (1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws."

The income tax acts have consistently allowed deduction for exhaustion, wear and tear, or obsolescence only in the case of "property used in the trade or business." The taxpayers in these cases could not, therefore, have claimed any deduction on this account for years prior to that in which the casualty occurred. For this

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[2] c. 277, 48 Stat. 680, §§ 23 (e) (f) (h) (l), 24(a)1, 41, 113; 26 U. S. C. §§ 23, 24, 41, 113.

[3] c. 209, 47 Stat. 169, §§ 23 (e) (f) (g) (h), 24(a)1, 113.

reason they claim they may deduct upon the unadjusted basis,—that is,—cost. As the income tax laws call for accounting on an annual basis; as they provide for deductions for "losses sustained during the taxable year"; as the taxpayer is not allowed annual deductions for depreciation of nonbusiness property; as section 23(e)(3) requires that the deduction shall be on "the adjusted basis provided in section 113(b)", thus contemplating an adjustment of value consequent on depreciation; and as the property involved was subject to depreciation and of less value in the taxable year, than its original cost, we think section 113(b)(1)(B) must be read as a limitation upon the amount of the deduction so that it may not exceed cost, and in the case of depreciable non-business property may not exceed the amount of the loss actually sustained in the taxable year, measured by the then depreciated value of the property. The Treasury rulings have not been consistent, but this construction is the one which has finally been adopted.[4]

In No. 180 judgment reversed.
In No. 318 judgment affirmed.

A true copy.

Test:

Clerk, Supreme Court, U. S.

[4] Treasury Regulations 86, Arts. 23(e)-1, 23(h) 1, 113(b) 1; G. C. M. XV 1, Cumulative Bulletin 115-118.